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January 16, 1996

Mr. William F. Caton, Acting Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Washington, D. C. 20554

DOCKET FILE COPY ORIGINAL

In the Matter of:

Price Cap Performance Review for Local Exchange Carriers	))	CC Docket No. 94-1 Fourth Further Notice of Proposed Rulemaking

Dear Mr. Caton:

Enclosed are an original and nine copies of the Comments of Cincinnati Bell Telephone in the above referenced proceeding. Two additional copies are being provided to the Tariff Division and a computer disk copy of the attached Comments is being provided to the Industry Analysis Division, as instructed in paragraph 152 of the Commission's Fourth Further Notice of Proposed Rulemaking in the above referenced docket. A duplicate original copy of this letter and attached Comments is also provided. Please date stamp this as acknowledgment of its receipt and return it. Questions regarding these Comments may be directed to Ms. Patricia Rupich at the above address or by telephone on (513) 397-6671.

Sincerely,

Peggy A. Peckham

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Director - Legislative &
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
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COMMENTS OF CINCINNATI BELL TELEPHONE COMPANY

I. INTRODUCTION

Cincinnati Bell Telephone Company ("CBT"), an independent, mid-size local exchange carrier ("LEC"), submits these comments in response to the Commission's September 27, 1995 Notice of Proposed Rulemaking ("NPRM") in the above-captioned proceeding.[1] In this NPRM, the Commission seeks comment on issues related to the development of productivity factors and sharing bands under price cap regulation.[2] CBT's comments focus on particular factors which, if modified, might make price cap regulation a more feasible option for small and mid-sized companies. CBT also briefly addresses issues raised in the Commission's Second NPRM on LEC Pricing Flexibility which relate to productivity factors.[3]

Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, Fourth Notice of Proposed Rulemaking, released September 27, 1995.

2 NPRM at ¶ 12.

Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1; Treatment for Operator Services Under Price Cap Regulation, CC Docket No. 93-124; Revisions to Price Cap Rules for AT&T, CC Docket No. 93-197, Notice of Proposed Rulemaking, released September 20, 1995, at ¶¶ 159-161.

Currently, CBT is subject to Optional Incentive Regulation ("OIR") for interstate access services.[4] When the Commission developed the OIR rules for small and mid-size LECs, OIR was envisioned as a step on a continuum toward price cap regulation and away from rate of return. These rules recognized the fact that small and mid-size carriers required additional flexibility to respond to increased challenges.[5] CBT initially elected OIR because it provided a degree of regulatory and pricing flexibility that did not exist under rate of return regulation. CBT determined that under the Commission's price cap regulations, small and mid-size service providers, such as CBT, would be unable to meet the price cap productivity levels.[6]

Periodically, CBT reassesses whether to remain under OIR regulation or to consider moving to price cap regulation. With every evaluation, CBT has determined that it should remain under OIR regulation. CBT is concerned that the Commission continues to articulate regulations which are rigid and provide little flexibility for small and mid-size companies, keeping them and CBT from electing price caps.[7]

The rules articulated by the Commission for OIR became effective on June 11, 1993. *(See,* Report and Order, CC Docket No. 92-135, *adopted* May 13, 1993, *effective* June 11, 1993.) CBT's initial tariff filing under the OIR regulations was made on October 1, 1993, with an effective date of January 15, 1994. In March of 1995, CBT filed its first biennial OIR tariff filing.

Report and Order, CC Docket No. 92-135, *adopted* May 13, 1993, *effective* June 11, 1993.

This conclusion was supported by a productivity study submitted to the Commission by CBT on June 19, 1989. *See*, CBT's Comments, CC Docket No. 87-313, filed June 19, 1989.

Although CBT discusses the advantages of OIR over price cap regulation, there are some negative results from operating under OIR. CBT hopes, however, that by pointing out a few differences in price cap and OIR rules the Commission will understand why additional LECs have not chosen price cap regulation. Changes to the price cap

II. DISCUSSION

In its original LEC Price Cap Order, the Commission established a price cap index ("PCI") for various categories of LEC access services.[8] The PCI represents the maximum price level that LECs may charge for services covered by the index.[9] With regard to developing the formula to determine the PCI for each category of access services, the Commission is seeking comments on issues related to the calculation of the X-Factor, various methods employed to compute the X-Factor, a means of updating the X-Factor, the number of X-Factors necessary, and the relationship of X-Factor levels to sharing requirements.[10]

A. CBT Advocates Elimination Of X-Factors And Earnings Sharing.

With competition, price caps are unnecessary as market forces govern LEC prices. As competitors vie for customers, LECs will pass operational efficiencies on to customers in the form of lower prices. In the absence of competition, X-Factors serve to prevent carriers from making excessive profits when costs are on a downward trend as a result of greater cost efficiency. The X-Factor provides regulators with an ex ante guarantee of lower prices, while earnings sharing provides further ex post price reductions. To a certain degree, X-Factor values and earnings sharing accomplish the same objective, that is, they act as surrogates for a competitive market.

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plan will encourage selection of this pricing regulation.

Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, 5 FCC Rcd 6786 (1990)("LEC Price Cap Order"). See also, NPRM at ¶ 2.

9 NPRM at ¶ 2.

10 NPRM at ¶ 14.

CBT believes strongly that productivity factors and earnings sharing are unnecessary in a competitive environment and should be dropped from the price cap formula. Unfortunately, the Commission seems predisposed to continuing the application of these adjustments. No rational relationship exists between multiple X-Factors, earnings sharing bands and levels of pricing flexibility, so there is no way to determine how to combine these factors to achieve an optimal incentive structure. To compound the difficulty of this issue, the determination of an X-Factor value and measurement is itself an arduous process. Adding arbitrary connections to earnings sharing bands and flexible pricing rules further exacerbates this complex issue. Incentive regulation mechanisms should be simple and logical, so that both carriers and regulators better understand their financial effects.

B. CBT Supports Simplified Total Factor Productivity ("TFP") Calculations.

If the Commission does decide to continue to employ X-Factors in the context of price cap regulation, CBT believes that price caps could be made more appealing to small and mid-size LECs if the method of calculating the X-Factor is simple and does not involve the use of proprietary data. The use of X-Factors to create and maintain incentives is effective only if those factors are not subject to manipulation and are understood well enough to allow for intelligent decision making.

CBT supports a total factor productivity method to calculate the X-Factor. However, CBT is concerned that the Christensen method is too complex, requires the use of proprietary data, and will be costly for small and mid-size companies to calculate.[11] CBT asserts that a simpler method

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[11] NPRM at ¶¶ 22-76.

of calculation must be developed in order to make price caps attractive to small and mid-size LECs.[12]

C. CBT Opposes The Development Of A Single X-Factor For All LECs Operating Under Price Cap Regulation.

The Commission has requested specific comment on whether a long term price cap plan should include multiple productivity factors or only a single productivity factor. The primary reason to allow a regulated firm to choose from regulatory options is to induce the firm to use its superior information about its operations to promote economic efficiency. The regulated company will often have better information than the regulator about its production costs, customer demand, competitors' activities, and future productivity gains. When the company has superior information, it can be induced to select a productivity target that best matches its capabilities, as long as appropriate incentives are provided for it to do so.

In order to encourage more LECs to choose to operate under price cap regulation, CBT believes that the Commission must develop multiple X-Factors. A single X-Factor would not reflect differences in the economic conditions faced by each individual LEC, nor does a single X-Factor reflect the differing economies of scale, the market conditions faced by the specific LEC or the historical pricing and earnings philosophy of the LEC. A single X-Factor developed by the Commission would, of necessity, be set at some mid-range level, so that it would operate as fairly as possible for all LECs under price cap regulation. However, the choice of such a mid-range figure by the Commission would be completely arbitrary. In this situation, some LECs could

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[12] CBT is in the process of analyzing alternative calculations of TFP.

easily reach the X-Factor level, while others would find such a level completely impossible to reach, depending on the operating circumstance of the LEC.

If the Commission were to choose to set a single X-Factor at a level which was either too high or too low, then certain LECs or their customers would be penalized by decreased revenue or higher prices. Thus, the Commission would have no choice but to select some mid-range point at which to establish a single X-Factor. However, the establishment of such an X-Factor level will not be an incentive for small and mid-size non-price cap companies to voluntarily submit to price cap regulation. These companies, including CBT, have currently chosen not to operate under price cap regulation due to the need to attain an impossibly high X-factor, even now with three levels of X-Factors to choose from. Such companies certainly would have no incentive to choose to operate under price cap regulation if there were only one X-Factor available.

Under no circumstances would it be appropriate for the Commission to assign mandatory X-Factors to individual companies as proposed in the Second NPRM (Issue 19).[13] Such an assignment would presume that it is possible for the regulator to have better knowledge of individual company characteristics and conditions than the company itself. LECs must be given the flexibility to respond to changes in market size, competitiveness, and customer demand, which are rapidly changing in a competitive environment. In addition, mandatory X-Factors would be difficult, if not impossible to manage.

Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1; Treatment for Operator Services Under Price Cap Regulation, CC Docket No. 93-124; Revisions to Price Cap Rules for AT&T, CC Docket No. 93-197, Notice of Proposed Rulemaking, released September 20, 1995, at ¶¶ 159-161.

CBT asserts that for the reasons outlined above, the Commission, if it decides to continue X-Factors, should establish multiple X-Factors in the long-term price cap plan. The development of multiple factors would insure that the plan can be made to fit the particular circumstances of each price cap LEC. CBT proposes that a lower level of X-Factors be offered to smaller companies. Past CBT data has shown that smaller companies cannot meet the productivity factors which the Commission has articulated for larger LECs.[14]

Carriers that serve relatively small numbers of customers and primarily produce services with historically small profit margins and limited growth potential might be eligible to select from options which have a relatively small X-Factor. Larger carriers with superior growth and profitability potential on the other hand might be eligible to select from other options. Each of the options afforded the larger carriers might entail a higher X-Factor than the options provided to the smaller firms. In this manner, the set of options provided to both large and small carriers can reflect the broad knowledge available to the Commission concerning the carriers' capabilities based on common characteristics, while still permitting the carriers to use their awareness of their specific capabilities to choose the appropriate X-Factor within the range of options. CBT also asserts that LECs should have the flexibility to select different X-Factors each year. This is particularly important as the effects of competition may substantially change a company's productivity gains from year to year.

While the multi-tiered regulatory mechanism CBT proposes may be somewhat more complicated to implement, the benefits promised from accounting properly for both major

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See, the productivity study submitted to the Commission by CBT on June 19, 1989. *See*, CBT's Comments, CC Docket No. 87-313, filed June 19, 1989.

observable and unobservable differences among carriers seems likely to outweigh any additional costs. This will also provide an incentive for small and mid-size firms to elect price cap regulation.

D. <u>CBT Opposes The Current Lifetime Rule For Price Cap Regulation</u>.

Under current regulations, once a company makes the decision to operate under price cap regulations, it may not alter this choice, even if such an election should prove to be economically problematic. CBT asserts that such a "lifetime" rule of election is a disincentive for smaller LECs, keeping them from choosing price cap regulation. CBT believes that if the Commission wishes to increase the number of smaller LECs electing to operate under price cap regulations, it must give them the ability to return to their previous form of regulation if circumstances warrant.

CBT recommends that the Commission adopt rules which provide for an elective price cap classification, under which a company which chooses to operate under price cap regulation must continue to do so for a minimum of four years. At the end of this period, the company may then choose to remain under price cap regulations, return to rate of return regulations or elect to operate under OIR regulations. Such flexibility would provide an incentive for smaller LECs to consider operating under price cap regulation, while providing them a mechanism to respond to their changing circumstances.

III. CONCLUSION

CBT strongly urges the Commission to develop modifications to the current price cap regulatory system which will make those regulations a more attractive option for small to mid-size LECs. In addition, in a competitive market, X-Factors and earnings sharing should be eliminated.

Respectfully submitted,

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Dated: January 16, 1996

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CERTIFICATE OF SERVICE

The undersigned hereby certifies that copies of the foregoing **Comments of Cincinnati Bell Telephone Company** have been delivered by first class United States Mail, postage prepaid, on January 16, 1996, to the persons on the attached service list.

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Amy K. Collins

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